CHAPTER 7

INCOME TAXES

Contents

INTRODUCTION

All American citizens and resident aliens must pay tax on their worldwide income.

Every year you must prepare for the Internal Revenue Service (IRS) an accounting of where your income came from, what your exemptions and deductions might be and what you might owe in tax to the U.S. Government. Every January you should receive a set of tax forms and basic instructions from the IRS. You can also call or write the IRS to request the forms, or check the IRS's Web site: http://www.irs.gov. Forms can also be picked up at the Employee Services Center (Foreign Service Lounge), certain IRS and state offices, banks, libraries, and post offices. Each post abroad should also have a supply.

You prepare a similar accounting for your state of domicile if it has an income tax. You should receive a set of tax forms from your state as you do from the IRS. Otherwise check with your state's Office of the Comptroller.

STATE TAXES

Regulations concerning state income tax should also be checked with the appropriate authorities. The *Foreign Service Journal* prints a summary of state tax requirements every year, usually in its February issue (see http://www.afsa.org/taxguide2002.html). In general, the information in this section applies to both state and federal taxes, but there are exceptions. The important thing to remember is that most states and the District of Columbia require that Foreign Service personnel continue to pay taxes while on assignment abroad. States that do not have income tax are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. New Hampshire and Tennessee have no tax on personal income but do tax businesses and profits from the sale of property and bonds. States for which there is no tax liability for out-of-state income if the individual has no permanent residence, has a permanent residence elsewhere, and is not present in the state more than 30 days during the tax year include: Connecticut, Missouri, New Jersey, New York, Pennsylvania, and West Virginia.

Some states consider you liable for taxes if you have been physically present in that state more than 183 days of the calendar year although domiciled in another state. If you have any uncertainty about your liability to a state jurisdiction, consult, prior to departure if possible, the state tax authorities. If you are a member of the American Foreign Service Association (AFSA), you may consult the association's tax expert. If you fail to meet your state tax obligation, you will be faced with all unpaid taxes, plus interest and penalties.

FEDERAL TAXES

The following discussion is organized according to the basic tax form for federal taxes, Form 1040, and its supporting schedules. The IRS publishes a number of booklets that help explain issues regarding Form 1040, and some are described in this chapter. You can also check the IRS's Web site for similar information: http://www.irs.gov. Various publishers have produced tax information guides that try to cover the whole field in one book. They often have good indices so that you can easily find the information you need. You may consult http://www.afsa.org/taxguide2002.html for tax information specific to the Foreign Service.

INCOME

To prepare your tax return, you must first figure out your income. In January, employers send each employee a set of W-2 forms. These forms give totals for the amount earned in the previous year and show the federal and state taxes withheld. One copy of each set of W-2s must be sent with your tax return to the IRS and another to the state(s) to which you owe tax. An additional copy is for you to keep with your copy of your tax return.

Other income must also be reported. Interest from bank and credit union accounts and dividends earned by shares of stock are considered income and are listed on Schedule B. Banks and companies send you Form 1099 to report interest and dividends earned. Use the information on these forms to fill in Schedule B. Interest earned on money loaned to someone also must be reported. More information is given in IRS Publication 17, "Your Federal Income Tax."

Money earned from self-employment is taxed, including freelance work such as tutoring, catering, or selling your written work or artwork. Certain expenses incurred in connection with self-employment may be deducted; these are listed on Schedule C, the form used to report this kind of income. (It is essential to keep good records of expenses if you plan to deduct them.) Refer to Publication 17 for the definition of hobby income and deductions.

Earning more than $400 annually from self-employment requires that you pay Social Security tax by using Schedule SE.

Many Foreign Service spouses find self-employment attractive as a means of earning additional credit toward Social Security retirement benefits, particularly when they are serving abroad and are unable to continue regular employment. Some income earned abroad, however, is exempt from Social Security tax. This is an area that must be explored carefully.

If you sell a capital asset, such as stocks, bonds, or real estate, you must pay tax on the profit.

Losses, except on the sale of your personal residence, are deductible. Capital gains and losses are reported on Schedule D. Net capital loss from Schedule D is limited to $3,000 per year, or $1,500 if married and filing separately, with balance carried over to future years' Schedule D.

The current capital-gains exclusion on the sale of a principal residence on or after May 7, 1997, applies to all homeowners, regardless of their age. The current tax laws allow an exclusion of up to $500,000 for couples filing jointly and up to $250,000 for single taxpayers on the gain from the sale of their principal residence. It is to your benefit to research this area thoroughly to familiarize yourself with the intricacies of and qualifications to this exclusion. Above all, keep good records of purchase price, costs of improvements, and documents such as deeds and titles and settlement sheets.

In addition to Publication 17, other good sources of information are the following:

- Publication 523, "Selling Your Home";
- Publication 530, "Tax Information for First-Time Home Owners";
- Publication 554, "Older Americans' Tax Guide."

Rental income you receive is taxable and is reported on Schedule E. If you show a net loss on Schedule E from all rentals, you are allowed up to $25,000 of such loss against your other income. However, if your adjusted gross income exceeds $100,000, you will lose 1 dollar of any rental loss for every 2 dollars of income above $100,000, until at $150,000 adjusted gross income you are not allowed any rental loss at all. Unallowed loss has been in the law since 1986.

The tax is paid on net rental income after deducting expenses such as repairs, property taxes, mortgage interest, insurance, and management fees. You also want to deduct depreciation. Depreciation is a difficult subject, but it is worth researching carefully. Begin by reading Publication 17 and, perhaps, Publication 527, "Residential Rental Property." If you still find it unclear, consult a tax advisor.

Form 1040 provides space for reporting other income, such as taxable pensions, IRA distributions, unemployment compensation (part of which could be taxable), or alimony received. The portions of Foreign Service and Civil Service annuities that exceed what the employee paid into the retirement system are taxable. Social Security benefits have been partially taxed since 1984 and need to be reported. Keep records of any Social Security benefits you receive. Child support payments are not taxable.

Separate Maintenance Allowances, like most allowances Foreign Service employees receive while serving abroad, are not taxed and need not be reported. Note, however, some allowances (primarily the Post Differential and Danger Pay) are considered extra compensation and are taxed; these will be included in the W-2 statement of income received at the end of the year. In addition, tax-exempt interest, although not taxed, must be reported, and may not be exempt on your state returns.

ADJUSTMENTS TO INCOME

The next major section of Form 1040 covers adjustments to income. In this section, you claim eligible contributions to Individual Retirement Accounts (IRAs) or Keogh plans, alimony payments, reimbursed employee business expenses (where the reimbursement had been included in your gross income), self-employed health insurance deductions, and penalties on early withdrawal of savings.

IRAs

If neither you nor your spouse is covered by an employer retirement plan, you can claim full IRA deductions. Each worker is allowed to contribute up to $3,000 of earnings into an IRA every year and deduct that amount on his/her return. For double-income couples, each spouse is permitted to contribute $3,000, for a combined maximum deposit of $6,000. Single-income couples are allowed to make a tax-deductible contribution of $6,000.

If you or your spouse is covered by a pension plan at work, you still may be able to claim an IRA deduction depending on your income. If your adjusted gross income (before subtracting the IRA contribution is below $53,000 on a joint return or less than $33,000 for individuals, you can take a full IRA deduction. For couples with income between $53,000 and $63,000, a partial IRA deduction is allowed.

If you open an IRA at a bank or other institution to set aside money for retirement, neither the amount invested nor the interest earned through the years is taxed until you withdraw it, by which time you will presumably be in a lower tax bracket. If you take it out before you are 59 ½ years old, you pay a 10 percent penalty. If you cannot claim any IRA deduction, you are still allowed to put up to $3,000 a year into an IRA, and the interest or dividends you receive will not be subject to tax until you take them out of the IRA. If you are self-employed, you may set aside money for retirement under a Keogh plan. Publication 17 and Publication 590, “Individual Retirement Arrangements,” contain more information about both IRAs and Keoghs.

Foreign-Earned Income Exclusion

Family members may benefit from the Foreign Earned Income Exclusion while working overseas. This applies to work on the local economy or work performed as an independent contractor, even if for the U.S. Embassy. It does not apply to any interest earned or salaries paid by the U.S. Government. If you are paid by the U.S. Government under a non-personal services contract (meaning that the agency for which you work does not control your work functions, work facilities, work hours, etc.), your earnings may be excludable. To be eligible in any instance, you must have been outside the United States for 330 days out of a full 365-day year. To find out if you qualify for the foreign-earned income exclusion, obtain Form 2555, "Exemption of or Reduction from Income Earned Abroad," with instructions.

DEDUCTIONS

At this point you have determined your adjusted gross income (AGI). You now need to consider your deductions. The standard deduction differs according to your filing status, which is explained further in the instructions accompanying Form 1040 and in Publication 17. If you are single or head of a household, look up the definition before you claim this status. There is also a phase-out of Schedule 1040-A totals when AGI exceeds $114,700. You lose 3 percent of each dollar income above $114,700 from your Schedule A deductions. (See this Schedule in your tax booklet from the IRS.)

For federal taxes, the status "married filing a separate return" is disadvantageous because the tax rates are higher. However, on most state tax returns, the lowest tax often results when spouses split their income. Each claims his/her own salary or wages, and earnings from separately owned bank accounts, stocks, rental property, etc. Jointly owned earnings from dividends, interest, and rents are divided equally. Deductions may be allocated in any way that reduces your tax. In the District of Columbia, Virginia, and Maryland the form has two parallel columns, one for each spouse. You may use whichever filing status results in the lower tax.

If your deductions total more than the standard deduction, you may itemize them on Schedule A. You must have good records to prove that the deductions you claim are valid, in case you are challenged by the IRS.

Medical/Dental Expenses

You may deduct only certain items, summarized on Schedule A and described more fully in Publication 17 and Publication 529, "Miscellaneous Deductions." Medical insurance premiums paid by you, drug expenses (for prescription drugs and insulin only), and other medical and dental expenses are deductible to the extent that they exceed 7.5 percent of adjusted gross income. Transportation to source of medical care at 12 cents a mile plus parking fees and tolls can be included. Publication 17 tells you more, as does Publication 502, "Medical and Dental Expenses."

Real Estate Expenses

You may deduct the interest portion of your home mortgage. If your house is rented while you are abroad, you can deduct the taxes and mortgage interest from the rent received, using Schedule E. For Interest Expense, see Publication 17. Mortgage "points" on the loan on the house you live in are deductible on Schedule 1040. If paid through refinancing, they are amortized over the life of the loan paper.

Charitable Contributions

You may deduct charitable contributions and perhaps even the use of your car and other out-of-pocket expense for volunteer work connected with charitable purposes within certain limits (for example, only U.S.-based charities are eligible). See Publication 17 and Publication 526, “Charitable Contributions.”

Business Expenses

Business travel expenses include airplane, bus, railroad and taxi fares, auto rental expenses and mileage, baggage transfer costs, cleaning expenses, hotel expense, meals, telephone expense, and tips. The best substantiation for a business travel expense is a receipt. For expenses such as mileage in a personal automobile, a contemporary written record is usually sufficient. You should keep a diary to show such expenses. A claim for meal expenses can be made in two ways. You can claim the exact costs, using a receipt for substantiation. Or, you can claim a standard amount without submitting receipts, but in this event you must have receipts for lodging and travel covering the period for which you claim the meal expenses. (Any food or entertainment expenses claimed must be reduced by 50 percent before entering on Schedule 1040A.)

Unreimbursed and documented expenses incurred during training while on temporary duty (TDY) orders for periods of less than 12 months may be deducted as employee business expenses. Use Form 2106 to file claims for lodging for you and accompanying family members, based on actual costs; meals, estimated on a reasonable basis; and books and other training expenses. The claims may be accompanied by a statement from the Director of the Department of State's George P. Shultz National Foreign Affairs Training Center (Shultz Center) or other appropriate official to the effect that your training was a temporary assignment and that you were either not entitled to per diem or entitled to only a limited amount. (It is not necessary to include this statement when filing, but is helpful in case of an audit.) If you took a course at the Shultz Center between two overseas posts and the government shipped your family car directly to the next overseas post, the cost of car rental is also deductible, if not reimbursable.

You do not need to submit your substantiation to the IRS with your tax return, but you should have receipts and an expense diary along with a copy of your travel orders, in case of an audit.

Home Leave Expenses

Substantiated home leave expenses of a U.S. Foreign Service employee are deductible business expenses. However, the employee's family members' personal and living expenses are non-deductible. Business travel expenses include airplane, bus, railroad, and taxi fares, baggage transfer costs, dry cleaning, hotel, meals, telephone, tips, auto rental, and mileage.

Claim home leave expenses on Form 2106. Attach a statement explaining that you are a Foreign Service employee on mandatory home leave, giving dates. If you traveled with family members, explain how you have allocated expenses between them and yourself. Keep all receipts and records of other expenses (such as an expense diary) along with a copy of your travel orders, in case of an audit. Keep your income tax records for at least three years in case you are audited.

Moving Expenses

To be eligible for a moving expense deduction, you must be at post at least 39 weeks during the 12-month period immediately after arrival. Moving expense deductions cannot be taken if you retire or resign within those 39 weeks. However, if departure from post is unexpected and involuntary, the deductions are allowed.

Deductions are allowed (Form 3903) for any legitimate expenses not covered by government allowances, such as:

- Cost of shipping effects in excess of government allowances

- Shipping pets
- Transit insurance for effects and cars
- Unreimbursed losses incurred during shipment
- Disconnecting utilities (does not include telephone)
- Cost of shipping a second car, or the first car if it is foreign made and not covered by the government
- Extra cost of first-class air travel, if you select it in lieu of economy class
- Cost of transporting a family member who may be ineligible to travel at government expense
- Actual cost of lodging in excess of per diem payments for official travel

Representation Expenses

Unreimbursed entertaining (representation) expenses also can be claimed, although this is one area the IRS often questions. Read Publication 463, "Travel, Entertainment, Gift and Car Expenses."

Keep records of all official representation such as restaurant bills or home entertainment accounts to show the amount spent, time and place of function, representational purpose, and position and official relationship to those entertained. These can justify business expense deductions if certified by the post fiscal officer as performed in the interest of the government and as prescribed in the employee's job description but not reimbursed due to insufficiency of funds. On Form 2106 show the total amount claimed, any amount reimbursed by the government, and the balance as your deduction. Attach an itemized list showing date and type of expense, and relationship to Foreign Service activity.

Other Deductible Expenses

Losses of property due to theft or casualty above 10 percent of adjust gross income plus $100 are deductible under limited circumstances described in Publication 17.

Other deductible expenses are dues paid to professional organizations (including AFSA and AAFSW) or unions for government employees, professional publications, enrollment in classes or correspondence courses related directly to improving your job skills (not deductible if incurred to meet the minimum requirements of your profession or to qualify you for a new profession), and transportation to official functions at the rate of 34 1/2 cents per mile or the actual documented costs. Claim these on Form 2106.

On Schedule A, deduct safe deposit box rental fees and cost of tax consultants and tax preparation.

Specifically not deductible are losses due to foreign currency exchange and payments to a retirement fund. Also not permitted are direct contributions to foreign charities. However, some government employees have successfully defended contributions to foreign charities as unavoidable business expenses related to the proper conduct of business of diplomatic representation. Some have made their contributions deductible by routing them through American charitable organizations with overseas operations. But extreme scrutiny by IRS can be expected if such expenses are deducted.

Miscellaneous deductions are subject to a floor of two percent of your adjusted gross income; you can deduct only the excess above that amount. However, the moving expense deduction and a few others are not subject to the two-percent floor.

It is very important to maintain and retain careful records of expenditures and reimbursement, and to obtain post certification of expenses related to transfer or conduct of official diplomatic representation.

EXEMPTIONS

When you are overseas in government employment, you will not enjoy any exemptions from federal, state, or, where applicable, city personal income taxes.

When stateside, you get exemptions for yourself, your spouse, and each dependent. (You must have a Social Security number for all dependents over two years old.) If claimed on your return, the dependent cannot claim an exemption on his/her own return. The five conditions that must be met before a person may be listed as your dependent are described in Publication 17, as are the rules governing inclusion of adopted children and foster children as dependents.

The amount of your exemption may be reduced if your adjusted gross income is greater than $99,725. (A schedule for this is enclosed in your tax package each year.)

After determining your taxable income, you find your tax by looking in the tax tables that come with the instructions. Now determine if you are eligible for any of the following credits or deductions:

- Credit for child and dependent care expenses, if you paid someone to care for a child, disabled dependent, or disabled spouse so you could work or look for work. Limits and qualifications apply. See Form 2441, "Credit for Child and Dependent Care Expenses," and Publication 503, "Child and Dependent Care Expenses."
- Credit for foreign taxes paid. Use Form 1116, "Foreign Tax Credit," and see Publication 514, "Foreign Tax Credit for Individuals."
- Credit for the elderly (Schedule R and RP). Schedule RP may apply for a retired Foreign Service employee under age 65.

After subtracting the credits you might have to add other taxes, such as Social Security tax on self-employment income (Schedule SE).

REPORTING

After determining your total tax, compare it with the tax you have paid during the year. If you owe more, pay it by enclosing a check with your return. If you owe less, the IRS will send you a refund. Be sure to write your Social Security number on your check.

The law states that you must pay your taxes as you earn your money. For this reason, taxes are withheld from salaries. If the amount being withheld is insufficient, the employee should arrange to change the amount with the appropriate personnel officer. For Foreign Service employees and families whose income is mainly or entirely from Foreign Service salaries, the tax withheld should be adequate to cover most tax liability. However, if you have additional income, such as capital gains, interest, dividends, or self-employment income, it may be necessary to file a Declaration of Estimated Tax (Form 1040 ES) to prepay the additional tax in quarterly installments, or have payroll withhold more from your pay check. *Anyone taking a lump sum retirement or annuity benefit should be especially careful about these regulations.* The rules about who must file a Declaration of Estimate Tax are spelled out in Publication 17 and should be studied carefully; the penalties for underpaying the tax are substantial. Publication 17 also describes the conditions under which you may be excused from the penalty—90 percent of your total tax through withholding and quarterly payments, or, if you made quarterly payments on time and the total paid amounts to $1 more than you owed last year. This is a confusing area, and it may be advisable to consult a tax adviser.

Income of Child

The proper reporting of a dependent child's income can be somewhat difficult. Publication 17 describes the five conditions that must be met to claim a person as your dependent. One of these states that, generally, you may not take an exemption for a dependent if that person had a gross income of more than the exemption amount for the year. This restriction, however, does not apply to a child who is under age 19 or a full-time student under 24. For this reason, a student who works may request that his or her employer not withhold state and federal income taxes from the student's wages. If taxes are withheld, the student can file tax returns to claim a refund of the taxes paid. Note, however, that a child who has unearned income of $2,900 or more, such as interests or dividends, may have to pay tax on the unearned portion of income. This is an area where it is good to get advice.

Filing

Federal income tax is payable on or before April 15 each year. United States citizens and resident aliens who live abroad are given until June 15 to file their federal returns, but they must attach a statement indicating they were living and working outside the United States on April 15. They will be billed for interest from April 15, on any tax due.

If you cannot meet the April 15 deadline (or June 15, as described), you may file a Form 4868, "Application for Automatic Extension of Time to File." The automatic extension is four months, to August 15, which includes the two-month extension for overseas taxpayers. Note that the *extension of time to file does not mean extension of time to pay*. If you do not pay the estimated amount due at the time you file Form 4868, you will be assessed interest and penalty charges.

GENERAL ADVICE

Because tax calculation is complicated, you should stay informed of changes in regulations and allowances. Government publications, IRS booklets, and consultations with visiting tax specialists are ways to do this while you are overseas. You may want expert advice as to whether it is in your interest to itemize deductions or take the standard deduction. The expense of tax consultation is deductible.

If you are a do-it-yourself taxpayer, you will still need expert counsel if you have special concerns about community property income, if your spouse is a non-resident alien, if you are ordered to evacuate to a safe-haven post and incur expenses not covered by the government allowances, and/or if you believe the cost of domestic help or out-of-pocket costs constitute legitimate business expenses. Consider discussing your situation with a professional before departing for post. You will then be able to call upon that person as need arises with greater confidence that you will receive sound and timely advice.

When you go overseas, leave copies of tax records in a safe, accessible place in the United States so that you can get them easily in case of an emergency such as evacuation from post. Do not put them into storage with other household effects. Also, use an address on your return where you can be sure any notices sent by the IRS will reach you at least through several years in the future.

SOURCES OF INFORMATION

Overseas Briefing Center
Transition Center
George P. Shultz National Foreign Affairs Training Center
Room E2126
4000 Arlington Boulevard
Arlington, Virginia
Tel: 703-302-7277
Fax: 703-302-7452
Website: http://www.state.gov/m/fsi/tc

For mailing purposes:

Transition Center
Foreign Service Institute
Department of State
Washington, DC 20522-4201

Overseas Operations Division
Taxpayer Information Service
Internal Revenue Service
Washington, DC 20225
(Written inquiries only)

IRS Web site:
http://www.irs.gov

Tax relief estimator:
http://www.quicken.com/taxes/taxrelief/estimator/

Tax Guide of the American Foreign Service Association (AFSA)
It includes special sections on issues such as home ownership, tax liability upon sale of a residence, and state of domicile:
http://www.afsa.org/taxguide2002.html

For tax help on foreign-earned income, visit:
http://www.americantaxhelp.com